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TAGS: ECON EFIN ELAB IT KPRP
SUBJECT: The Italian Banking Sector: a Decade of Privatization and Consolidation

Summary

¶1. Since the mid-1990s, the Italian banking sector has undergone significant consolidation through mergers and acquisitions among major banks. The consolidation was the largest in Europe in terms of assets, and was driven in large part by domestic privatization efforts, Italy's entry into the European Monetary Union (EMU), and reforms to thwart monopolies. (See para three below). The end result has been four large banking groups (Banca Intesa, Unicredito, Capitalia, San Paolo-IMI) and two medium-sized banking groups (Monte dei Paschi di Siena and Banca Nazionale del Lavoro). Consolidation should make the Italian banking sector even more competitive in the single European market in coming years.

¶2. Privatization/consolidation has also reduced the formerly dominant state role. To replace government funds/capital, Italian banks have issued bonds as an alternative source of capital.

¶3. There has also been reform of monopolies, as EU competition policy and the Italian Antitrust Authority have pushed for more competition and transparency. Former Finance Minister Tremonti introduced a tough financial market oversight bill in response to the USD 18 billion Parmalat fraud. The original bill has been watered down, leaving the Central Bank's powers largely intact. The current draft of the law would strengthen the powers of the Companies and Stock Exchange Commission (Consob), Italy's securities markets regulator, by increasing its staff, giving it greater investigative powers and stiffening penalties for financial crimes. These changes will be incorporated into the bill that transposes the EU directive on market abuses into Italian law. The Central Bank's oversight authority will remain largely unchanged. Two separate bills will make additional changes to Italy's financial market regulatory framework, addressing such issues as bond issuance.

Consolidation In the Banking Sector

¶4. Until fairly recently, the Italian banking system was highly fragmented and inefficient, with high operating costs and excessive dependence on interest rate spreads for income. Restructuring, modernization, and privatization in the last decade have improved the efficiency of the banking sector. Consolidation stemmed principally from two factors - 1) privatization as a result of the GOI selling off public bank assets to ease the government's debt; and 2) EU regulations that encouraged liberalization.

Privatization: Amato/Ciampi Laws Weaken Banking Foundation

¶5. Until the 1990's, public institutions controlled more than 75 percent of the Italian banking sector, either directly by the GOI or through public banking foundations. The Italian banking foundations were more philanthropic than commercial in nature when they were first developed in the fifteenth century. In the early nineteenth century, the foundations established savings banks, which loaned money in their local regions, with profits remaining in the community. In the 1990's, the Amato and Ciampi banking reform laws privatized the banking foundations and separated their commercial and charitable roles. Private investors were then allowed to buy shares of the banks.

¶6. The Amato Law (218/1990) separated the functions of the philanthropic foundations and banks, and also encouraged the conversion of banks into joint stock companies. The foundations were each divided into two independent units, a commercial joint-stock bank, and the foundation as owner of the bank. Foundations were required to own a majority

share of the affiliated bank. The Ciampi law (Law 461/1998) then required foundations to sell their dominant ownership and limit it to ten percent by 2005 (recently

postponed to 2006). The process produced four large banking groups (Banca Intesa, Unicredito, Capitalia, San Paolo-IMI) and two medium-sized banking groups (Monte dei Paschi di Siena and Banca Nazionale del Lavoro).

European Monetary Union (EMU) Encourages Consolidation

¶7. Italy's archaic legal framework and banking supervision structure prior to EMU entry would not have allowed the Italian banking system to remain competitive within a unified European financial market. The process of entry into the EMU further consolidated the Italian banking system in the last decade and encouraged more efficiency. Thus, the first years of European Monetary Union (1998-2001) coincided with further consolidation among the largest Italian banking groups. Marcello Messori at the University of Rome Tor Vergata, told us that without this second wave of consolidation, the Italian banking groups would have been too small to compete in the future European market.

The Italian Banking System Today

¶8. From 1994 to 2003, mergers and acquisitions decreased the number of banks from 994 at the end of 1994 to less than 800 by the end of 2003. The process of consolidation in the last decade was the largest among European countries in terms of assets; about 60 percent of total Italian banking assets were involved. At present, Italy still has almost 800 banks with over 30,000 branches. However, as a result of consolidation, the top five Italian banks now control 54 percent of total bank assets in Italy, similar to France and Spain, but more concentrated than in Germany and in the United States. Nevertheless, Italy's banks are still small relative to other banks in Europe and other OECD countries. Consolidation is likely to continue as the Italian banking sector seeks to become more competitive in the global market.

¶9. The Bank of Italy (BOI), Italy's central bank, is generally considered to play an impartial role in Italian economic policy and supervision. The BOI's primary responsibilities are monetary management, financial supervision, and bank note authorization. As a result of the 1993 banking law, the banking system makes no distinction among commercial banking, investment, or savings banking, as it once did. The banking system is comprised of:

-- Joint stock companies (called Societ per Azioni, or SPA 244 at the end of 2003 with 23,617 branches in Italy), that provide credit to commercial entities and to private e
citizens nationwide.

-- Community or Peoples' banks (Banche Popolari 38 at end-2003 with 3,471 branches in Italy) that provide the same services as joint stock companies, but the capital of which is provided by a group of people wishing to open a bank. These banks are generally smaller than joint stock companies, ad operate mostly at a regional level. Some, eQpecially in northern Italy, have important relaQionships with industrialists in their district, tend to have more personal connections wih their customers, and have been expanding raidly. (Note: Banche Popolari Unite is Italy's hnargest number of banks in pe single branch banks witphin their small banki@ have historically

served Italy's many small and medium enterprises, and are less likely to be subject to consolidation.

-- Subsidiaries, branches, or representative offices of foreign banks.

¶10. Rank ordered by total assets, the major banks in Italy are: Banca Intesa, Unicredito, San Paolo, Banca Di Roma (Capitalia), Monte di Paschi di Siena, and Banca Nazionale del Lavoro (BNL). BNL is the only bank that has not been part of a recent merger or acquisition; while at the end of the 1990's BNL was the largest bank in terms of assets, it has now dropped to sixth.

¶11. The major Italian banks, like many large Italian companies, tend to have a pyramid-like ownership structure, with inter- and intra-group cross-shareholdings (as exists with Capitalia, Banca Intesa and Unicredito) allowing control over subsidiaries and other holdings despite directly owning only a small share of the controlled

entity. These pyramid holdings allow a bank with a minority stake and relatively small capital in a major company to take control through its relationship with companies in the layers of the ownership pyramid.

¶12. About 61 foreign banks offer services in Italy, through branches, subsidiaries, or representative offices. The largest block of foreign banks are from the UK, Germany, France, Luxembourg, Belgium, the Netherlands and the United States. U.S. banks with offices in Italy include Chase, Citigroup, Morgan Guaranty Trust, Bank of New York, Bank of America, Mellon and Morgan Stanley.

¶13. Since northern Italy is more industrialized than the south, most foreign bank branches, subsidiaries, and representative offices are located there (83 percent), with 67 percent in Milan. There is only one foreign bank branch in the entire south (Mezzogiorno), located in Bari. Moreover, institutions headquartered in the North control the great majority of bank branches in the South.

Privatization Brings More Capital to Banks . . .
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¶14. After privatization began in the late 1990's, Italian banks issued stocks and bonds as an alternate source of capital to government funds. This development increased bank ownership by individuals and companies, and GOI holdings decreased proportionately.

...But also Broken Bonds

¶15. In addition to selling bonds to raise their own capital, Italian banks also began to offer brokerage services to corporations by selling corporate, foreign or government bonds. There have been several financial scandals recently that have raised questions about the banks' management of this process. Many investors claim the banks misled them by selling these bonds without explaining the associated risk. Argentina's default in 2001 affected 400,000 Italians holding euro 14.7 billion in Argentine bonds; food processor Cirio's collapse in 2003 hurt 30,000 Italian savers holding euro one billion in Cirio bonds; and in 2004, the dairy group Parmalat's insolvency affected 100,000 small investors holding euro 1.9 billion in Parmalat paper. Bankers have denied culpability and have been generally unrepentant about the damages caused to investors.

¶16. Many banks have thus been reluctant to settle with bondholders, but there have been some banks such as San Paolo IMI who have reimbursed their clients. Capitalia, Italy's fourth largest bank has compensated either fully or partially its 3,800 clients holding bonds of Cirio, Parmalat and another distressed company, Giacomelli. Despite the compensation, many Italians are now suspicious of bonds and the banks that sold them.

Interrelationships Between Banks and Companies
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¶17. The Bank of Italy (BOI) retains significant authority over bank mergers and acquisitions, and rigid controls restrict ownership relationships between banks and corporations. For example, Bank of Italy authorization is required for both domestic and foreign non-banking companies to acquire more than five percent of a financial institution's capital (or to gain effective control of a financial institution, regardless of the amount of capital acquired). The BOI must also approve the acquisition by banks of more than five percent of a company. The pyramid-shaped ownership system is the banking sector's response to BOI supervision and control. Moreover, the BOI encouraged some banking mergers while discouraging others.

¶18. According to Silvano Carletti, Manager of Banking Competition at Rome's Banca Nazionale del Lavoro, Italian banks can be shareholders of non-financial companies providing the following three conditions are met:
- A bank's investment in non-financial companies cannot exceed fifteen percent of total shareholder funds;
- Investment cannot exceed fifteen percent of the capital of the non-financial company; and
- Any single investment must be less than three percent of the banks market capitalization.

¶19. Over the last decade, BOI governor Antonio Fazio has made clear his goal to first consolidate internally Italy's banking sector before opening it to outside competition. Despite these limitations, foreign banks have established a stake in Italy's largest banks and have increased their total stake in the Italian banking sector from 7.1 percent in 1997 to 12.3 percent in 2002. Credit Agricole and Commerzbank control fifteen percent and 4.3 percent, respectively, of Banca Intesa, Italy's largest bank.

Santander Central Hispano and Deutsche bank control 9.7 percent and 2.5 percent, respectively, of San Paolo IMI. Banco Bilbao Vizcaya controls fifteen percent of Banca Nazionale del Lavoro, and ABN Amro holds nine percent of Capitalia and twelve percent of Banca Antonveneta, Italy's ninth largest bank active in the north. ABM Amro considers Italy its second domestic market and, like the Spanish banks Banco Santander Central Hispanico (BSCH) and Banco Bilbao Vizcaya (BBVA), has been frustrated with the investment caps. These banks continue to press for the elimination of the BOI 15 percent limit imposed on foreign shareholders.

¶20. Comment: While BOI restrictions on ownership between companies and banks prevent excessively cozy relationships between banks and corporations, the restrictions also limit foreign investment that could bring new technology and innovation to the Italian banking sector. Some critics also believe the limitation on foreign investment in local banks has inhibited Italian banks from joining larger international groups that are more competitive within the single EU market. End comment.

Banking and Financial Supervision

¶21. Both the 1993 Banking Law and the 1998 Consolidated Law on Financial Intermediation (the Ciampi law) delineate BOI supervisory objectives, including management of intermediaries and capital adequacy, ensuring compliance with credit regulations, and securing a competitive and efficient system. The BOI also collaborates with the European Commission to ensure compliance with EU directives.

The Role of the Antitrust Authority

¶22. Both EU liberalization directives and the Italian Antitrust Authority have helped push Italian banks towards competition and transparency. The Antitrust Authority was created under a 1990 law and has oversight of the

following:

a) agreements that impede competition in the market,
b) abuses of dominant position, and
c) mergers and acquisitions which create or strengthen a dominant position to eliminate or restrict competition.

The Authority also enforces provisions of a 1992 law on misleading and comparative advertising. However, according to Professor Messori at the University of Rome Tor Vergara, the BOI still maintains primary supervisory/regulatory authority over the banking system.

Foreign Exchange Controls

¶23. In conformance with EU directives, Italy has no foreign exchange controls. There are no special exchange rates, and currency transfers are freely permitted. Similar to the U.S., banks and authorized intermediaries must submit data on any foreign exchange transaction exceeding euro 10,329 to the Bank of Italy.

The Basel Accord and Italian Banks

¶24. European Central Bank President Jean-Claude Trichet describes the Basel Accord as "enhancing banks' safety and soundness" by establishing, inter alia, capital requirements according to individual bank risk and the credit-worthiness of their loans. Basel Accord capital requirements are also flexible enough to relax capital requirements for low-risk banks with a good credit history.

¶25. Observers here generally see Basel Accord capital requirements as potentially freeing up capital and encouraging lenders to lend more efficiently and with less risk to stimulate stronger economic growth in Italy. While in the past, Italian banks had based much of their lending on personal relationships with local firms, the Basel Accord has encouraged Italian banks to seek more creditworthy clients and not just service clients well known to management.

Comment: Where are Italian Banks Headed?

¶26. As a result of new EU regulations and new Italian deregulating provisions such as the Ciampi law, we expect to see more competition in Italy's banking sector, despite the limitations on bank ownership. (See para 6 above). An increase in mergers and acquisitions and more foreign competition will push consolidation as it leads to a more competitive and efficient banking system. We expect to see

the implementation of some measures strengthening financial
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market oversight, but we do not expect to see a revival of efforts to transfer competence over banking competition regulation from the BOI to the Italian antitrust authority. Such a transfer was proposed in former Finance Minister Tremonti's draft savings oversight bill, which has been watered down by the Parliament and GOI. BOI Governor Fazio can be counted on to stoutly resist any effort to weaken BOI authority.

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